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THE WHITE HOUSE

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MEMORANDUM FOR THE CABINET COUNCIL ON NATURAL RESOURCES AND ENVIRONMENT

FROM: DONALD PAUL HODEL
THE SECRETARY OF ENERGY Don Hodel

SUBJECT: Natural Gas Deregulation

INTRODUCTION

A paper giving detailed background and discussion of the general problems and avenues for solution of the natural gas situation was distributed for the Cabinet Council meeting of January 6, and a copy is attached for your information.

Pursuant to Cabinet Council direction, I have met or spoken with many of the key members of Congress concerned with the natural gas situation and with representatives of natural gas producers, transporters, purchasers, and consumers. Based on that examination, I am presenting the following report and recommendation.

Any comprehensive natural gas bill, in order to be taken seriously and to have a prospect of success, must address three major areas:

1. Deregulation. Provide for the ultimate deregulation of all gas by a specific date, so that a true market system can ultimately prevail.

2. Contract Adjustment. Some action must be taken concerning contracting practices which were virtually compelled by the regulatory system, but which could be extremely damaging during the transition out of controls.

3. Consumer Protection. Some element of "consumer protection" so that this proposal cannot be characterized as "deregulation on the backs of the poor." We believe decontrol will not cause overall price increases. However, many of our supporters feel that to achieve passage of a bill with long-run benefits, we must assure consumers that there is a mechanism to limit short run cost to them.

Our objective is to assure the Nation an adequate supply of natural gas at a reasonable price. The best way to achieve that is a certain transition to a fully deregulated market, with an elimination of current distortions, and with the protection of consumer interest fully in mind.

RECOMMENDATION

Our recommendation involves allowing a free market whenever buyers and sellers make new contracts or renegotiate, combined with provisions to ensure that pipelines are encouraged to buy gas in a way that minimizes their average cost of gas. Our recommendation will provide maximum flexibility for renegotiation, while not allowing additional increases in gas prices under current ceilings, unless both parties agree. Newly discovered gas, as well as renegotiated contracts, would be deregulated, and the average of these deregulated prices would set a "gas cap" on the prices of all gas that was not renegotiated. There is substantial opinion that under current market circumstances, this "cap" would actually be lower than some of the prices permitted under the control system and would tend to bring prices down.

We would anticipate that most gas contracts would be renegotiated over the next 2 years and thus a deregulated market would be arrived at. However, for gas which was not renegotiated, in 1985, the purchaser could get out of any such contract (presumably high-priced contracts), and the seller could get out of any remaining contracts (presumably low-priced contracts) and sell their gas elsewhere.

In any event, the key consumer protection feature would be that, in contrast with current law, each gas pipeline (which buys gas from producers and sells it to users or local utilities) could not pass on automatically any increased gas costs above inflation. Thus, if a pipeline could negotiate down expensive contracts as it negotiated up ones now frozen at low prices, it would have no problems. And this is what we expect would happen in the majority of cases. If, however, the pipelines insisted on buying high-cost gas -- imported or supplemental, or expensive gas from itself -- then its price increases could not be passed through automatically. They would have to justify those increases to the FERC in a public proceeding under appropriate standards.

Any gas which a pipeline purchaser refused to take or abrogated its contract for could be sold to any other purchasers and the pipeline would be obliged to arrange transportation. In the same way, if a buyer and seller could make a deal for the purchase of other gas, the FERC could require that transportation be arranged over existing pipelines, if capacity were available. In short, a much broader market would be created where buyers and sellers could compete freely and thus introduce more of the element of competition which has been so successful in reducing oil prices.

This initiative would also repeal the Fuel Use Act, which restricts the use of natural gas, and incremental pricing, which requires that especially high prices be charged to certain industrial customers. It would also provide that all buyers could compete freely for gas wherever located in the country, on-shore or off-shore.

In addressing deregulation, we rejected an immediate decontrol option as both politically unsaleable and overly abrupt. A standard phased decontrol, of the type recommended last year, has the defect of specifying a particular upward path of prices, and also of still limiting the flexibility of buyers and sellers to renegotiate immediately.

On contract adjustments, we rejected more stringent take-or-pay limitations as disruptive to financing, while the 70 percent number is fairly close to where industry practice seems to be going. By providing a limitation on indefinite escalators for a certain period of time, we avoided specific and complicated rewriting of those clauses. The ultimate abrogation of contracts, when not renegotiated, is certainly distasteful, but in the circumstance of contracts having been entered into under a completely different mechanism of control, it appeared to be the best solution to force serious renegotiation, while ultimately allowing both buyers and sellers a way out of untenable contracts that were not renegotiated.

In looking at consumer protection devices, we basically proceeded on the premise that average acquisition costs of natural gas would probably not increase as a result of decontrol, but that consumers would demand something more than just an assurance. We considered and rejected a specific windfall profits tax with distribution of money for energy purposes, both because of our general opposition to such taxes, and because the money once collected could probably not be distributed equitably only to those who were suffering as a result of gas price increases. We also rejected a proposal to collect money retroactively from producers and return it to consumers if prices ultimately went up, primarily because of extreme difficulty of administration, as well as its retrospective nature as opposed to the prospective nature of an ordinary tax.

SUMMARY

As is obvious from the above, the natural gas situation is an exceedingly complicated one, and almost any solution will have a number of complicated features. Discussion with Congress and "fine tuning" will be necessary both before and after the introduction of legislation. What is needed is a firm decision on a commitment to produce a bill, and a general choice of the direction to pursue.

<u>OPTION 1</u> (Decontrol on renegotiation, with limitation on automatic pipeline price pass-through)

<u>Advantages</u>

- Allows new gas decontrol, and maximum flexibility on renegotiations.
- Provides incentive for most efficient exploration and production of natural gas.
- Provides very strong consumer protection by limitation on pipeline pass-through.
- Provides no specific upward price path to be attacked.
- Pipeline pass-through limitation will ensure a strong incentive to obtain gas on a reasonable least-cost basis.
- Allows direct market on a broad basis between sellers and consumers.

<u>Disadvantages</u>

- Should arouse extreme opposition from pipelines.
- Can be attacked as indirect price control by control of automatic pipeline pass-throughs.
- Will be attacked for allowing decontrol of any gas any time that the current buyer and seller agree.
- Could be argued it too severely transforms the current gas marketing system.

<u>OPTION 2</u> (Do nothing)

<u>Advantages</u>

- Avoids an immediate political fight on our initiative.
- Current situation is perceived by some as not too bad, as price gap between oil and gas is diminishing and even reversing.
- Avoids the possibility of Administration initiatives leading to an ultimate bill worse than the present situation, which the President would have to decide whether to veto.

Disadvantages

- Hurts consumers by leading to increased prices and decreased supply over the long run.
- Leaves initiative in hands of proponents of controls, who will in any event continue to press for further restrictions on gas prices.
- Prevents most effective and efficient production and use of natural gas, thus exacerbating energy problems.
- Could hurt consumers by maintaining artificially high prices over the short to mid-term, especially if oil price goes down.
- Practically guarantees a fight over reimposition or extension of controls in the 1984 political season.
- Will further discourage rational exploration and conservation efforts as natural gas situation remains unsettled.

DECISION

Approve Initiative ___________

Approve as Modified ___________

Do Nothing ___________